



Department of Finance  
Canada

Ministère des Finances  
Canada

Report on the

# **Management of Canada's Official International Reserves**

APRIL 1, 2013 – MARCH 31, 2014

Canada

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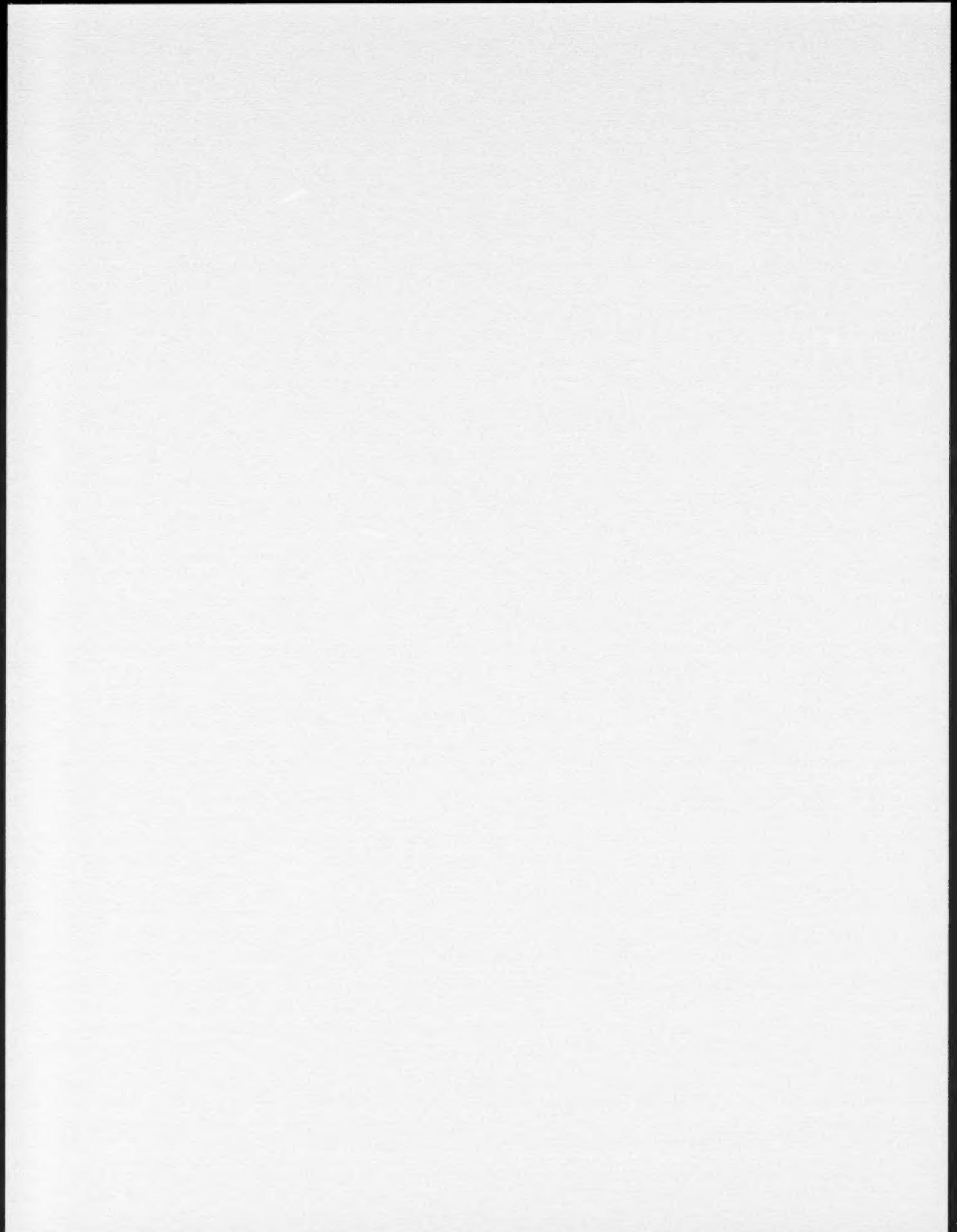
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## Purpose of the Report

This edition of the *Report on the Management of Canada's Official International Reserves* provides details on official international reserves operations from April 1, 2013 to March 31, 2014 (the 2013–14 fiscal year).

As required under the *Currency Act*, the report provides a comprehensive account of the framework within which the Exchange Fund Account (EFA) is managed, its composition and changes during the year, and strategic policy initiatives, as well as a statement of whether the strategic objectives established for the EFA have been met.

Consistent with amendments made to the *Currency Act* in 2012, the Office of the Auditor General of Canada now performs EFA-related audit work only in support of its audit opinion on the *Public Accounts of Canada*, as opposed to also providing a distinct audit opinion on the financial statements of the EFA. Accordingly, the financial statements presented in this annual report are marked unaudited.

Unless otherwise noted, in this report, the official international reserves are reported in US dollars on a market-value basis. The unaudited financial statements that appear at the end of this report are in Canadian dollars, as reported in the *Public Accounts of Canada*.

### Exchange Fund Account

The EFA, which is held in the name of the Minister of Finance, represents the largest component of Canada's official international reserves. It is a portfolio that is primarily made up of liquid foreign currency securities, special drawing rights (SDRs), and a small holding of gold. SDRs are international reserve assets created by the International Monetary Fund (IMF) whose value is based on a basket of international currencies. In addition to the EFA, Canada's official international reserves include Canada's reserve position at the IMF. This position, which represents Canada's investment in the activities of the IMF, fluctuates according to drawdowns by and repayments from the IMF.

The legislative objective of the EFA, as specified in the *Currency Act*, is to aid in the control and protection of the external value of the Canadian dollar. Assets held in the EFA are managed to provide foreign currency liquidity to the Government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required. Under the *Currency Act*, the Minister of Finance has the authority to acquire, borrow, sell or lend assets held in the EFA in accordance with the *Statement of Investment Policy* (see Annex 1).

The Department of Finance and the Bank of Canada jointly develop and implement the investment policy and funding program of the EFA. As fiscal agent of the Government, the Bank of Canada executes investment and funding transactions and manages EFA cash flows.

A detailed description of the EFA's management framework is provided in Annex 2. The framework includes the objectives, principles and governance structure of the EFA. Annex 2 also describes the policies that pertain to investments, risk management, performance measurement and foreign currency funding activities.



## Highlights

The *Currency Act* stipulates that this report provide a statement of whether the strategic objectives established for the EFA have been met during the review period. These objectives—to maintain a high standard of liquidity, preserve capital value and optimize return—were achieved.

**Level of the official international reserves:** The market value of Canada's official international reserves increased to \$76.5 billion as at March 31, 2014 from \$70.2 billion as at March 31, 2013. The change comprised a \$6,027-million increase in EFA assets and a \$215-million increase in the reserve position in the IMF. EFA assets, which totalled \$71.8 billion as at March 31, 2014, were held at a level that is consistent with the Government's commitment to maintain holdings of liquid foreign exchange reserves at or above 3 per cent of gross domestic product. EFA assets are composed primarily of the debt securities of highly rated sovereigns, their agencies that borrow on public markets and are supported by a comprehensive government guarantee, and supranational organizations.

Table 1

### The EFA and Official International Reserves

market value in millions of US dollars, settled basis

	March 31, 2014	March 31, 2013	Change
Securities	62,394	56,782	5,612
Deposits	612	331	281
<b>Total securities and deposits (liquid reserves)</b>	<b>63,006</b>	<b>57,113</b>	<b>5,893</b>
Gold	124	165	-41
SDRs	8,709	8,534	175
<b>Total EFA</b>	<b>71,839</b>	<b>65,812</b>	<b>6,027</b>
IMF reserve position	4,611	4,396	215
<b>Total official international reserves</b>	<b>76,450</b>	<b>70,208</b>	<b>6,242</b>

**EFA composition:** As at March 31, 2014, the US-dollar share of EFA liquid investments was US\$43.5 billion or 69 per cent, the euro share was equivalent to US\$19.1 billion or 30.3 per cent, the yen portion was equivalent to US\$297 million or 0.5 per cent, and the pound sterling share was equivalent to US\$181 million or 0.3 per cent.

Investments in fixed-income securities of sovereigns and agencies made up 87.6 per cent of EFA liquid investments while 11.8 per cent was invested in securities issued by supranational organizations. Less than 1 per cent was held in cash.

EFA investments are assigned a credit rating based on the second highest rating among those provided by Moody's Investors Service, Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service. As of March 31, 2014, 90 per cent of liquid reserve investments were rated AAA and 99 per cent were rated AA+ or better.

**EFA funding sources:** The foreign currency reserve assets held in the EFA and the foreign currency liabilities financing these assets are managed on a portfolio basis and are matched closely in currency and duration, in order to limit the Government's exposure to currency and interest rate risk.



During 2013–14, EFA operations were financed through cross-currency swaps of domestic obligations and direct issuance.

Cross-currency swaps totalling \$5.4 billion were transacted at an average cost of 3-month US\$ LIBOR (London Interbank Offered Rate) less 39 basis points. This compared to an average rate of 3-month US\$ LIBOR less 35 basis points for 2012–13.

In February 2014, a 5-year \$3-billion global bond was issued at a cost of 3-month US\$ LIBOR less 1 basis point. Priced at 11 basis points over the comparable US Treasury security, this was the tightest pricing versus Treasuries for a 5-year global bond since Canada's last issue in February 2012. This transaction was met with very strong demand, with interest from over 150 high-quality investors from around the globe. In addition, \$675 million of medium-term notes was issued at an average funding cost of 3-month US\$ LIBOR less 5 basis points.

The level of outstanding short-term US-dollar commercial paper issued under the Canada bills program was maintained around \$2.0 billion over the period, at an average cost of funding of 3-month US\$ LIBOR less 16 basis points, which was higher than the previous year's funding level (US\$ LIBOR less 22 basis points).

**Portfolio return:** In 2013–14, the EFA earned an average positive spread (or net “coupon return”) of 22 basis points, down from 39 basis points the previous year. This spread represents the difference between the yield to maturity on foreign currency fixed-income assets held in the EFA and the average cost of foreign currency liabilities used to fund the assets. The spread measures the underlying net return of the portfolio on the assumption that all the assets and liabilities are held to maturity and the coupons are reinvested at their respective yield to maturity.

Taking into account gains and losses on portfolio rebalancing and coupon flows (i.e., cash flow basis), the EFA portfolio earned 25.5 basis points (or a gain of \$95 million) in 2013–14, down from 80 basis points (or a gain of \$351 million) the previous fiscal year.

Taking into account cash flows and unrealized changes in the market value of assets and liabilities due to changes in interest rates and credit spreads, the EFA reported a total return of 71 basis points in 2013–14. This is equivalent to a mark-to-market gain of \$406 million. Like the previous year, in which the EFA reported a total return of 95 basis points (or a gain of \$532 million), the gain was mainly driven by improvements in credit spreads in the market, particularly in the euro area.

## Report on Operations in 2013–14

The following sections describe the impact of market developments on the EFA, portfolio performance and risk measures, and policy and program initiatives undertaken in 2013–14.

### Market Developments

#### Interest Rates

During the 2013–14 reporting year, interest rates in the United States and Germany rose, while rates in other areas of Europe fell. Overall, changes in interest rates in 2013–14 resulted in a decrease of \$1,455 million in the market value of the reserves.



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US-dollar-denominated holdings in the EFA are composed mainly of fixed-income securities issued by the US government and supranational institutions. After starting the 2013–14 year at historically low levels, short-term and longer-term interest rates in the United States increased after the Federal Reserve hinted on May 1, 2013 that it might begin scaling back its third round of quantitative easing by reducing its monthly bond purchases. The reduction in quantitative easing would reduce the overall demand in Treasuries, putting upward pressure on interest rates. Market participants reacted quickly to the release, sending yields on the US 10-year benchmark bond sharply higher. The Federal Reserve announced the first of a series of reductions in its bond purchase program in December 2013. Interest rates fell during the final quarter of 2013–14 on geopolitical concerns after Russia's annexation of Crimea. Over the year, the yield on US 3-month Treasury bills was little changed while the yield on 10-year Treasury bonds rose by 89 basis points.

Euro-denominated holdings in the EFA are composed of fixed-income securities issued by European countries, their agencies, and supranational institutions. The European Central Bank reduced its key policy rate to a record low of 0.25 per cent as growth on the continent fell short of expectations and concerns about deflation surfaced. Bond yields in European peripheral countries fell for the second consecutive year. However, in Germany, the yield on 10-year Bunds rose by 26 basis points during the year.

### **Credit Spreads**

Credit spreads on fixed-income securities issued in US dollars narrowed during the year given continued accommodative monetary policies and search-for-yield considerations as the global economy continued to grow at a moderate pace. Credit spreads of European sovereign periphery bonds narrowed relative to German government bonds. Overall, there was an approximately US\$268.7-million increase in the market value of reserves due to the narrowing of credit spreads.

### **Exchange Rates**

Overall, exchange rate changes versus the US dollar resulted in an increase of \$1.7 billion in the market value of the reserves. The foreign reserves are managed under an asset-liability matching framework and, as a result, exchange rate movements had a relatively minor impact on the Government's financial position, as reported in the *Public Accounts of Canada*.

During 2013–14, the euro appreciated by approximately 4 per cent against the US dollar, which was mainly due to the continued expansionary monetary policy maintained by the US Federal Reserve. As 30 per cent of the liquid reserves were held in euro-denominated securities (as at March 31, 2014), changes in the value of the euro against the US dollar had a positive impact on the market value of the reserves.

During 2013–14, the yen fell 9 per cent against the US dollar due to the unprecedented expansionary monetary policies undertaken by the Japanese government. Changes in the yen/US-dollar exchange rate, while significant, had little impact on the market value of the official international reserves since only 0.5 per cent of the reserves were held in yen-denominated assets as at March 31, 2014.



## Initiatives in 2013–14

During 2013–14, the Department of Finance and the Bank of Canada continued to work on initiatives to improve the management of the EFA. These initiatives included reviewing and updating the EFA's decision-making framework for allocating assets within the portfolio, establishing a medium-term note program and reducing the mechanistic reliance on external credit ratings. As a result of domestic and international reforms to the over-the-counter derivatives market, the Department of Finance and the Bank of Canada worked on revising the collateral policy for the Government's derivatives program. In addition, the gold coins sales program concluded in January 2014 and the list of eligible investments in the EFA was broadened to include pound sterling-denominated assets.

### Asset Allocation Framework Review

The Treasury Evaluation Program periodically assesses treasury management policies and operational programs to ensure effectiveness, provide accountability, and ensure policies and programs are aligned with Government of Canada objectives. Under this program, Forethought Risk completed an evaluation of the asset allocation framework of the EFA in March 2012. The findings of the evaluation and the recommendations are available at <http://www.fin.gc.ca/treas/evaluations/eaafefa-ecracfc-eng.asp>. The Department of Finance, in collaboration with the Bank of Canada, has been undertaking work to address the recommendations stemming from the evaluation, including developing a more formal investment process, establishing an investment benchmark, and enhancing risk and performance metrics.

### Medium-Term Note Program

The Government of Canada successfully launched a medium-term note pilot program in November 2013. This program provides the Government with additional flexibility to raise foreign currency. The program allows for issuance in a number of currencies, including the US dollar, euro and pound sterling, using either a US or euro medium-term note prospectus.

### Reducing Reliance on Credit Rating Agencies

In line with principles to reduce the mechanistic reliance on external credit ratings, the Bank of Canada has set up a Credit Rating Assessment Group (CRAG) within the Financial Risk Office. The CRAG supports a Credit Ratings Committee, which is composed of Department of Finance and Bank of Canada officials responsible for assessing the credit quality of trading and investment counterparties of the EFA. During 2013–14, the CRAG began work on the development of methodologies to conduct internal rating assessments.

### Over-the-Counter Derivatives

The Government of Canada uses foreign exchange swaps and cross-currency swaps to fund the purchase of EFA assets and to hedge currency movements related to IMF activities. These transactions are executed with a range of counterparties through bilateral contracts under the International Swaps and Derivatives Association documentation. The contracts include collateral support agreements to mitigate market and credit risk associated with the swaps.

In 2013–14, the Department of Finance and the Bank of Canada launched a series of consultations with counterparties on the Government's collateral and margining policies for swaps. These policies are being updated to reflect guidance on margin requirements for non-centrally cleared derivatives as agreed by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.



## Gold Coins Sales Program

The centennial anniversary sale of King George V \$5 and \$10 gold coins dated 1912, 1913 or 1914, which was officially launched in November 2012, concluded in January 2014. On behalf of the Government of Canada, the Royal Canadian Mint sold all of the 30,000 high- and medium-quality gold coins held in the EFA.

The program generated revenue of over C\$25 million (Table A4.1) for the EFA over 2012–13 and 2013–14. After accounting for overhead costs, which included packaging, advertising, transportation and program management fees paid to the Royal Canadian Mint, the net profit to the EFA was approximately C\$23 million. The 30,000 gold coins contained over 13,000 ounces of gold. The proceeds from the sales have been reinvested in highly liquid securities, consistent with the policy objectives of the EFA.

At the end of March 2014, the EFA held 95,895 ounces of gold in the form of low-quality King George V coins. The Government also retained 36 pristine King George V coins, representing six sets of each denomination and year, for archival purposes.

## Addition of Pound-Denominated Assets to the Exchange Fund Account

The Department of Finance and the Bank of Canada conducted a study in November 2012 to determine whether adding other currencies to the EFA could increase the liquidity and diversification of the portfolio. The analysis concluded that the addition of pound sterling (GBP)-denominated assets would meet the objectives of the EFA. In 2013–14, the Government of Canada broadened the list of eligible investments in the EFA to include GBP-denominated assets. At the end of the reporting period, the GBP share was equivalent to US\$181 million or 0.3 per cent of EFA assets.

## Performance Versus Strategic Objectives

The *Currency Act* stipulates that this report provide a statement of whether the strategic objectives established for the EFA have been met during the review period. These objectives—to maintain a high standard of liquidity, preserve capital value and optimize return—were achieved. The planned level of liquidity was maintained for the reserves portfolio throughout the reporting period, and the portfolio's exposure to market and credit risks was managed within acceptable limits. In addition, the net underlying return was positive (see Annex 4).

## Term Structure of the Official International Reserves

Table 2 shows the distribution of investments in the official international reserves by currency and term to maturity as at March 31, 2014. US-dollar holdings, which made up slightly more than 70 per cent of the reserves, were roughly equally distributed across the under 6 months, 1 to under 5 year, and 5 year and over maturity buckets. The euro holdings were more heavily weighted towards the 1 to under 5 year and 5 year and over maturity buckets. Yen holdings remained minimal and relatively unchanged from the previous year. Pound sterling holdings were minimal and were focused in the 1 to under 5 year and the 5 year and over maturity buckets.

Gold, SDR holdings and the IMF reserve position, which have no terms to maturity, are translated into US dollars. The IMF reserve position is classified as an investment of indefinite term.



Table 2

**Term Structure of the Official International Reserves as at March 31, 2014**

market value in millions of US dollars, settled basis

Term	Cash and term deposits	Government securities in domestic currency	Other securities	Gold	SDR holdings	Total EFA assets	IMF reserve position	Total official international reserves
<b>US-dollar holdings</b>								
Under 6 months	555	9,269	6,701	—	—	<b>16,525</b>	—	<b>16,525</b>
6 months to under 1 year	—	261	861	—	—	<b>1,122</b>	—	<b>1,122</b>
1 year to under 5 years	—	8,821	6,419	—	—	<b>15,240</b>	—	<b>15,240</b>
5 years and over	—	9,091	1,474	—	—	<b>10,566</b>	—	<b>10,566</b>
Indefinite term	—	—	—	124	8,709	<b>8,833</b>	4,611	<b>13,444</b>
Total US-dollar holdings	555	27,442	15,455	124	8,709	<b>52,286</b>	4,611	<b>56,897</b>
<b>Euro holdings</b>								
Under 6 months	47	1,373	278	—	—	<b>1,697</b>	—	<b>1,697</b>
6 months to under 1 year	—	244	220	—	—	<b>464</b>	—	<b>464</b>
1 year to under 5 years	—	6,648	1,821	—	—	<b>8,469</b>	—	<b>8,469</b>
5 years and over	—	7,634	811	—	—	<b>8,445</b>	—	<b>8,445</b>
Total euro holdings	47	15,899	3,130	0	0	<b>19,075</b>	0	<b>19,075</b>
<b>Yen holdings</b>								
Under 6 months	9	—	—	—	—	<b>9</b>	—	<b>9</b>
6 months to under 1 year	—	—	—	—	—	—	—	—
1 year to under 5 years	—	287	—	—	—	<b>287</b>	—	<b>287</b>
5 years and over	—	—	—	—	—	—	—	—
Total yen holdings	9	287	0	0	0	<b>296</b>	0	<b>296</b>
<b>GBP holdings</b>								
Under 6 months	2	—	—	—	—	<b>2</b>	—	<b>2</b>
6 months to under 1 year	—	—	—	—	—	—	—	—
1 year to under 5 years	—	90	—	—	—	<b>90</b>	—	<b>90</b>
5 years and over	—	89	—	—	—	<b>89</b>	—	<b>89</b>
Total GBP holdings	2	179	0	0	0	<b>181</b>	0	<b>181</b>
<b>Total</b>	<b>612</b>	<b>43,807</b>	<b>18,585</b>	<b>124</b>	<b>8,709</b>	<b>71,838</b>	<b>4,611</b>	<b>76,449</b>



## Liquidity and Preservation of Capital

In practice, the EFA's liquid reserves (which exclude gold and SDR holdings) are mainly invested in the debt of sovereigns and their agencies with a comprehensive government guarantee (87.6 per cent as at March 31, 2014), as these securities both enhance the liquidity and preserve the capital value of the EFA (Table 3). A more detailed description of the changes in the level of the official international reserves is provided in Annex 3.

Table 3

### Composition of EFA Liquid Reserves

market value in millions of US dollars, settled basis

	March 31, 2014	March 31, 2013	Change
Sovereigns and agencies	55,207	49,288	5,919
Supranationals	7,388	7,495	-107
Private sector investments	0	0	0
Cash	411	331	80

The largest portion of EFA liquid reserves is in US dollars because foreign currency needs are mostly in US dollars and, historically, foreign exchange market intervention has mainly consisted of transactions involving the US dollar. As at March 31, 2014, the US-dollar share of EFA liquid investments was US\$43.5 billion or 69.0 per cent, the euro share was equivalent to US\$19.1 billion or 30.3 per cent, the yen portion was equivalent to US\$297 million or 0.5 per cent, and the pound sterling share was equivalent to US\$181 million or 0.3 per cent (Table 4). By comparison, as at March 31, 2013, the US-dollar share was 67.0 per cent, the euro share was 32.5 per cent and the yen share was 0.5 per cent.

Table 4

### Currency Composition of EFA Liquid Reserves

market value in millions of US dollars, settled basis

	March 31, 2014	March 31, 2013	Change
US dollars	43,452	38,253	5,199
Euro	19,076	18,550	526
Yen	297	310	-13
GBP	181	0	181

As specified in the *Statement of Investment Policy*, to help achieve the objective of preserving capital value, an issuing entity must have a credit rating of at least A-/A3/A (low) to be eligible for investment in the EFA. Counterparty limits are established based on a framework that incorporates external ratings from credit rating agencies. Compliance with counterparty limits is monitored on a real-time basis. The majority of EFA investments are in the AAA category, as indicated in Table 5.

As a result of the downgrade of several euro-area sovereigns, some securities held in the EFA are no longer rated at least A-.



Table 5

**Credit Composition of EFA Liquid Reserves**

market value in millions of US dollars, settled basis

	March 31, 2014	March 31, 2013	Change
AAA	56,585	53,905	2,680
AA+	5,784	2,474	3,310
AA	241	90	151
AA-	297	311	-14
A+	0	0	0
A	0	0	0
A-	0	0	0
Below A-	99	334	-235

**Portfolio Returns**

The EFA is a financial asset portfolio within the *Public Accounts of Canada*. For risk management purposes and to provide transparency on the net economic return or cost to the Government of maintaining the EFA, several performance indicators are measured and tracked on a regular basis and reported to senior management at the Department of Finance and the Bank of Canada. Of these performance indicators, coupon return and carry are reported at book value, while total return is reported at market value. A brief overview of the portfolio's performance is provided below (a more detailed description is provided in Annex 4).

**Overview**

Given the low interest rate environment and foreign exchange movements, the assets held in the EFA generated modestly higher net revenues in 2013–14 than in 2012–13 (C\$1.51 billion versus C\$1.40 billion). The cost of advances to the EFA, which represents the estimated economic cost to the Government of financing the EFA, modestly increased compared to the previous fiscal year (C\$1.53 billion versus C\$1.42 billion). In 2013–14, the cost of EFA advances was slightly higher than the net revenue earned on EFA assets, mainly due to decisions to exchange some lower credit quality assets, which were funded when interest rates were higher, with higher credit quality newly issued assets that pay lower coupons.



Table 6

**Summary of Main Performance Indicators for the Official International Reserves**

	April 1, 2013 to March 31, 2014	April 1, 2012 to March 31, 2013
1) Net revenue of the Exchange Fund Account (C\$ millions)	1,505	1,401
2) Net return on assets measures		
Coupon return (basis points)	22	39
Carry (basis points)	-24	-18
Carry including net realized gains or losses (basis points)	25	59
Total return (basis points)	71	95
3) Cost of advances to the EFA (C\$ millions)	1,527	1,416
	As at March 31, 2014	As at March 31, 2013
4) Risk measures		
Market risk (99% 10-day VaR, US\$ millions)	15	14
Credit risk (99.9% 365-day VaR, US\$ millions)	1,756	2,014

In 2013–14, the coupon return for the EFA, the difference between the yield to maturity of reserve assets and liabilities issued to fund the assets, was 22 basis points.

Two carry performance measures are used for the EFA: carry including only interest receipts and payments; and carry including interest receipts and payments as well as net realized gains and losses from the sale or purchase of assets. When net realized gains and losses are included in the carry measure, the carry improved from -24 basis points to 25 basis points.

Taking into account unrealized changes in the market value of assets and liabilities, the net value of the EFA increased by 71 basis points. This compares to an increase of 95 basis points in the market value of the EFA in 2012–13. The main driver was credit spreads on the funding side, and increased funding rates of interest led to a decrease in the present value of outstanding liabilities.

The Market Value at Risk (Market VaR), which measures the loss arising from interest rate and exchange rate movements that will not be exceeded 99 per cent of the time if the EFA is held static over a 10 business-day period, was relatively unchanged from the prior fiscal year (\$15 million versus \$14 million). The VaR measure of potential losses due to credit exposure to issuers (Credit VaR) decreased as a result of tighter credit spreads associated with somewhat improved funding costs for European sovereign issuers.

## **EFA Financing**

EFA assets are funded by borrowings from a variety of sources (Table 7). Funding requirements are partially met through an ongoing program of cross-currency swaps of domestic obligations. Total cross-currency swap funding and maturities during the reporting period were \$5.4 billion and \$3.4 billion respectively.

During 2013–14, foreign currency was raised through cross-currency swaps at an average cost of 3-month LIBOR less 39 basis points. This funding cost was better than rates obtained during the previous fiscal year, which averaged 3-month LIBOR less 35 basis points.



As at March 31, 2014, Government of Canada cross-currency swaps outstanding stood at US\$44.8 billion (par value). Swaps of US dollars, euro, yen and GBP made up 67.3 per cent, 31.7 per cent, 0.7 per cent and 0.4 per cent of the swap portfolio respectively.

The EFA can also be funded through direct foreign currency issuance using three programs: a short-term US-dollar paper program (Canada bills); a medium-term note issuance (Canada notes and euro medium-term notes); and a global bond program. The choice of direct issuance method depends on funding needs and market conditions.

The changes shown in Table 7 reflect issuance and maturities denominated in US dollars (as the foreign currency issues are reported in US dollars).

**Table 7**  
**Outstanding Foreign Currency Issues**  
 par value in millions of US dollars

	March 31, 2014	March 31, 2013	Change
Swapped domestic issues	44,767	41,376	3,391
Global bonds	11,755	8,564	3,191
Canada bills	2,021	2,001	20
Euro medium-term notes	125	0	675
Canada notes	550	0	0
<b>Total</b>	<b>59,218</b>	<b>51,941</b>	<b>7,277</b>

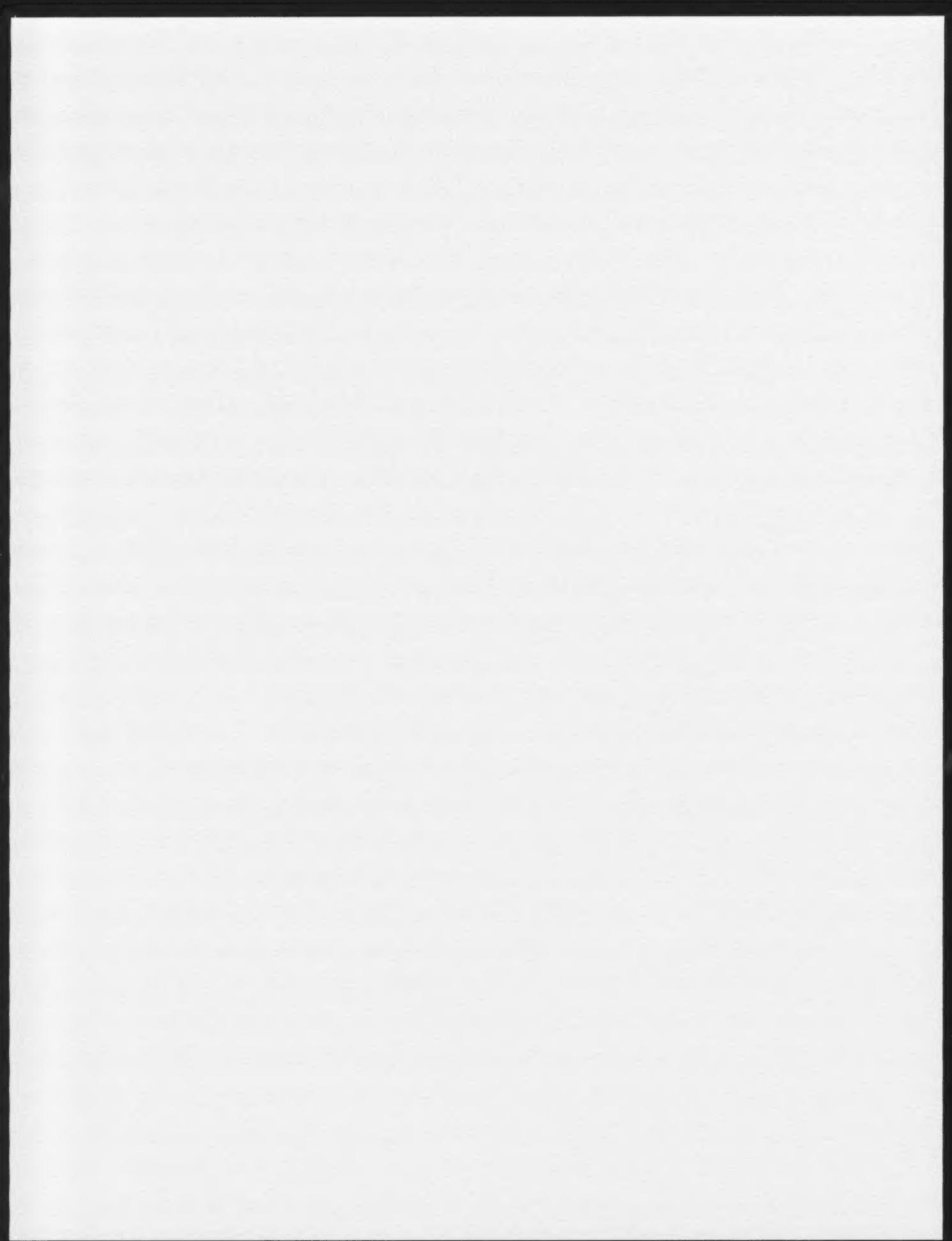
Further information on the management of foreign currency liabilities and the associated credit risks can be found in the *Debt Management Report* at [www.fin.gc.ca/dtman/2012-2013/dmr-rgd13-eng.asp](http://www.fin.gc.ca/dtman/2012-2013/dmr-rgd13-eng.asp).

### IMF Programs

The Government of Canada participates in two lending arrangements with the IMF outside of the quota system: the multilateral New Arrangements to Borrow (NAB) and General Arrangements to Borrow (GAB). Canada also participates in the Voluntary Standing Arrangement (VSA), which was put in place by the IMF to facilitate the purchase or sale of SDRs held by member countries. The objective of the VSA is to allow less developed countries to exchange SDRs for liquid currencies such as the US dollar. Under the VSA, Canada could be required to buy up to about \$4.5 billion of SDRs from other IMF member countries. Amounts advanced under these arrangements are considered part of the official international reserves of Canada and directly impact the Government of Canada's consolidated financial statements.

Canada's participation in the expanded NAB became effective on March 11, 2011. The maximum lending by Canada to the IMF under the NAB is limited to SDR 7,624 million. As at March 31, 2014, the amount outstanding under the NAB was SDR 974.56 million. Canada continues to participate in the GAB, which was most recently renewed in November 2012. The maximum lending by Canada to the IMF under the GAB is limited to SDR 893 million. As at March 31, 2014, no lending had been provided by Canada to the IMF under the GAB.

Funding of IMF activities during 2013–14 included \$600 million of issued cross-currency swaps and \$100 million of swap maturities.





## Annex 1: Statement of Investment Policy for the Government of Canada (June 2011)

### 1. Purpose of Policy

The *Statement of Investment Policy for the Government of Canada* sets out the policy, approved by the Minister of Finance under the *Currency Act*, governing the acquisition, management and divestiture of assets for the Exchange Fund Account (EFA).

### 2. Purpose of EFA

The purpose of the Exchange Fund Account (EFA) is to aid in the control and protection of the external value of the Canadian dollar. Assets held in the EFA are managed to provide foreign-currency liquidity to the Government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required.

### 3. Governance

Part II of the *Currency Act* governs the management of the EFA. As amended in 2005, the Act requires the Minister of Finance to establish an investment policy for EFA assets. Responsibility for the implementation of approved policy and strategy is delegated to officials of the Department of Finance and the Bank of Canada.

The *Bank of Canada Act* provides statutory authority for the Bank of Canada to act as the Government's fiscal agent in the management of the Government of Canada's Exchange Fund Account.

The Funds Management Committee (FMC), which comprises senior management from the Department of Finance and the Bank of Canada, is responsible for the oversight of EFA investments. For policy development, the FMC is supported by a Risk Committee (RC) and an Asset-Liability Management Committee (ALMC). The RC is an advisory body to the FMC that reviews and provide opinions on the risk implications while the ALMC is responsible for strategic planning and performance evaluation. The Financial Risk Office (FRO) at the Bank of Canada provides support to the RC and the ALMC on risk issues. Officials from the Department of Finance and the Bank of Canada are responsible for the implementation of the strategic plan and day-to-day management of investment. Further information regarding oversight and governance is available within the *Funds Management Governance Framework* document (available at [www.fin.gc.ca/treas/Goveev/TMGF\\_-eng.asp](http://www.fin.gc.ca/treas/Goveev/TMGF_-eng.asp)).

### 4. No Inconsistent Business or Activity

This policy prohibits any business or activity that is inconsistent with the investment objectives set forth below or in a manner that is contrary to the *Currency Act*.



## 5. Investment Objective

There are three investment objectives:

- *Maintain a high standard of liquidity:* Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- *Preserve capital value:* Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis<sup>1</sup> (in terms of currency and duration), and using appropriate practices to mitigate risks.
- *Optimize return:* Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

## 6. Investment Policy

### 6.1 Eligible Asset Classes

The EFA may hold the following classes of assets: 1) fixed income securities (including bonds, notes, bills and short-term discount notes/commercial paper) issued by sovereigns (including, central banks, and explicit agencies<sup>2</sup>) or fully-guaranteed by sovereigns, government-supported entities, sub-sovereign entities<sup>3</sup> and supranational institutions; 2) deposits with commercial banks, central banks and the Bank for International Settlements; 3) repurchase agreements; 4) commercial paper and certificates of deposit issued by private sector entities; 5) gold; and 6) International Monetary Fund (IMF) special drawing rights. Subject to section 6.9, bonds with embedded options (such as callable bonds) and holdings of securities issued by and deposits with Canadian-domiciled entities (or entities that derive a majority of their revenues from their Canadian operations) are not permitted. All other classes of assets not listed in this policy are prohibited.

### 6.2 Eligible Investment Ratings

Eligibility for investment in the EFA is based on external credit ratings. To be eligible for investment, an entity<sup>4</sup> must have a senior unsecured debt credit rating in the top seven categories from at least two of the four main rating agencies<sup>5</sup>: Moody's Investors Service, Standard & Poor's (S&P), Fitch Ratings and Dominion Bond Rating Service (DBRS). When credit ratings for an entity differ, the rating of the second highest rating agency will be used to assess eligibility<sup>6</sup>, consistent with the Basel II approach.

The only allowable unrated investments are the following: a) securities issued by and deposits with central banks and the Bank for International Settlements and b) investments in special drawing rights created by the IMF.

<sup>1</sup> Liabilities, which fund EFA assets, are managed outside the EFA.

<sup>2</sup> An agency is deemed to be explicit, if and only if, the government support is guaranteed by law.

<sup>3</sup> Sub-sovereigns are defined as levels of government within a sovereign territory, and hierarchically below the sovereign. For example, this could include, but not limited to, states, provinces or municipalities within a sovereign.

<sup>4</sup> Under exceptional circumstances, the credit rating of an entity's issuance may be used, at the discretion of the ALMC.

<sup>5</sup> EFA ratings of sovereigns are based on the lower of domestic and foreign currency ratings.

<sup>6</sup> Stand-alone credit ratings for commercial banks by Moody's (Bank Financial Strength Rating (BFSR)) and by DBRS (Intrinsic Assessments) will be used in conjunction with official credit ratings from S&P and Fitch to provide the relative credit quality of entities. The use of stand-alone ratings is to remove the assumption of implicit government support embedded in the official ratings of Moody's and DBRS. However, in cases where two or more ratings are the same, for example, Moody's is AA, S&P is AA, DBRS is AA- and Fitch Ratings is AA-, the EFA rating would be AA (not AA-).



## Eligible Ratings

Ratings agency	Minimum rating
Moody's Investors Service	A3 or better
Standard & Poor's	A- or better
Fitch Ratings	A- or better
Dominion Bond Rating Service	A (low) or better

## 6.3 Credit Exposure Limits

Exposure limits are based on credit quality for classes of assets, aggregate and individual counterparties.

### 6.3.1 Fixed Income Securities

Exposure to fixed income securities issued by sovereigns (including central banks and explicit agencies), government-supported entities, sub-sovereigns, and supranationals are shown in the tables below.

#### Limits on sovereigns in domestic and foreign currency (including central banks, and explicit agencies)—Aggregate limits

Issuer type	Aggregate limits (% of reserves target level)
"AAA"	Unlimited
"AA-" to "AA+"	25
"A-" to "A+"	2 (to be included in the above 25% limit)

#### Limits on sovereigns in domestic and foreign currency (including central banks, and explicit agencies)—Individual counterparty limits

Issuer type	Individual counterparty limits (% of reserves target level)
"AAA"	20 (Excluded from above would be direct domestic currency obligations of US, France, Germany and Netherlands)
"AA-" to "AA+"	10
"A+"	1.67
"A"	0.83
"A-"	0.33

#### Limits on Government Supported Entities (senior unsecured obligations) and sub-sovereigns—Aggregate limits

Issuer type	Aggregate limits (% of reserves target level)
"AA-" to "AAA"	25 (10% sub-sovereign limit)
"A-" to "A+"	2 (to be included in the above 25% limit)



#### **Limits on Government Supported Entities (senior unsecured obligations) and sub-sovereigns—Individual counterparty limits**

Issuer type	Individual counterparty limits (% of reserves target level)
"AAA"	3
"AA-" to "AA+"	1.5
"A+"	0.3
"A"	0.2
"A-"	0.1

#### **Limits on supranationals—Aggregate limits**

Issuer type	Aggregate limits (% of reserves target level)
"AA-" to "AAA"	25
"A-" to "A+"	2 (to be included in the above 25% limit)
Bank for International Settlements	10

#### **Limits on supranationals—Individual counterparty limits**

Issuer type	Individual counterparty limits (% of reserves target level)
"AAA"	10.0
"AA-" to "AA+"	5.0
"A+"	1.0
"A"	0.5
"A-"	0.2
Bank for International Settlements	—

### **6.3.2 Deposits and Other Short-Term Securities**

Individual actual exposure limits to private sector entities in the form of forwards, deposits, commercial paper and certificates of deposit, together with swaps used for funding purposes, are determined by credit rating, as shown in the following table. These limits are cumulative across all lines of EFA business and represent the mark-to-market value for swaps and forwards and the par-value exposure for deposits, commercial paper and certificates of deposit. Total exposure to private sector entities may not exceed 25 per cent of the reserves target level, including a maximum of 2 per cent of the reserves target level for private sector entities rated A+ to A-.



### Exposure limits by credit rating of private sector counterparties/issuers<sup>7</sup>—Total actual exposure

Issuer type	Total actual exposure (% of reserves target level)
"AA-" to "AAA"	25
"A-" to "A+"	2 (to be included in the 25% aggregate limit)

### Exposure limits by credit rating of private sector counterparties/issuers<sup>8</sup>—Individual actual exposure

Issuer type	Individual actual exposure (% of reserves target level)
"AAA"	1.00
"AA+"	0.67
"AA"	0.50
"AA-"	0.33
"A+"	0.17
"A"	0.08
"A-"	0.03

## 6.4 Structure of EFA Holdings

Investments will be held in either a Liquidity Tier or an Investment Tier. Only highly liquid US-dollar-denominated securities are eligible for investment in the Liquidity Tier: 1) sovereign (including explicit agencies and central banks) and "AAA" rated supranational securities; 2) US government-supported entity securities; 3) "AAA" rated US and European government-supported entity discount notes and commercial paper; 4) callable Bank for International Settlement deposits and medium-term investments; 5) overnight commercial bank deposits; 6) commercial paper and certificates of deposit issued by private sector entities; and 7) overnight repurchase agreements. Investment in EFA eligible securities, excluding securities held under the Liquidity Tier, is classified as investment in the Investment Tier.

## 6.5 Eligible Currencies

The Exchange Fund Account may hold US dollars, euros, and Japanese yen and IMF special drawing rights<sup>9</sup>. The minimum floor for US-dollar-denominated assets is US\$12 billion on a market-value basis.

<sup>7</sup> Exposure limits on deposits, commercial paper, and/or certificate of deposit will be determined at discretion of ALMC.

<sup>8</sup> Exposure limits on deposits, commercial paper, and/or certificate of deposit will be determined at discretion of ALMC.

<sup>9</sup> The Minister of Finance approved the addition of the pound sterling to the EFA in March 2013



## 6.6 Terms of Investments

The maximum term to maturity of EFA assets is based on type of instrument, credit rating and currency of issuance, as shown in the following table.

### Maximum Term to Maturity of EFA assets

Instrument	Maximum term to maturity
Marketable securities from issuers rated "AA-" or better	10.5 years
Investments from issuers rated from "A-" to "A+"	5 years
Commercial paper and certificates of deposit	1 year
Commercial bank deposits, repurchase agreements and all non-marketable instruments, such as deposits.	3 months

## 6.7 Permitted Activities

EFA officials may acquire or borrow assets to be held in the EFA and sell or lend those assets. Short sales are prohibited.

## 6.8 Use of Derivatives

EFA officials may use derivatives to mitigate risk and reduce costs. Derivatives shall not be used to establish speculative or leveraged positions.

## 6.9 Securities Lending and Repurchase Agreements

EFA officials may lend or borrow securities held in the EFA through a securities-lending program or repurchase agreements to enhance portfolio returns, provided it does not compromise liquidity or engender material exposure to loss. Officials are responsible for appointing and supervising agents, determining eligible collateral and setting collateral margins. Eligible collateral may include, but is not limited to, bonds with embedded options. Officials have the authority to either manage themselves or delegate to an agent the authority to select borrowers, negotiate terms to maturity and rates, and invest cash or securities collateral.

Individual exposure limits to private sector entities, in the form of repurchase ("repo") transactions, are determined by credit rating, as shown in the following table.

### Exposure limits by credit rating of private sector entities for repurchase transactions

Individual Counterparty Limits	EFA Credit Rating (% of the reserves target level)		
	"AAA"	"AA-" to "AA+"	"A-" to "A+"
Versus US Treasury and US Agency collateral combined	2.50	1.67	1.00



## 6.10 Exceptions

In exceptional circumstances such as a ratings downgrade or an event of default, the EFA may hold assets (acquired either through direct investment or by taking possession of collateral following an event of default) that do not otherwise meet the criteria for eligible asset classes and/or breach the credit exposure limits for up to a three-month period, or such longer period as the Minister of Finance may approve.

## 7. Performance Assessment and Risk Management

Officials are responsible for measuring, monitoring and reporting on the performance and risk exposures of the EFA and tracking these positions against appropriate indices. Performance and risk exposures will be reported on a timely and regular basis to the ALMC, the RC, the FMC, the Minister of Finance and Parliament. Measures should be consistent with leading practices in the private sector and provide information on the returns on EFA assets, the cost of associated liabilities and financial risks. Detailed information on the Government's risk management policies is provided in the *Government of Canada Treasury Risk Management Framework*.

## 8. Review

The *Statement of Investment Policy* will be reviewed annually and updated as required. Investment programs and practices should be subject to periodic external review to ensure that they contribute effectively to the achievement of EFA objectives.



## Annex 2: Overview of the Exchange Fund Account Management Framework

### Objective

- The legislative objective of the EFA, specified in Part II of the *Currency Act*, is to aid in the control and protection of the external value of the Canadian dollar. Assets held in the EFA are managed to provide foreign currency liquidity to the Government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required.

### Strategic Objectives

- **Maintain a high standard of liquidity:** Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- **Preserve capital value:** Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis (in terms of currency and duration), and using appropriate practices to mitigate risks.
- **Optimize return:** Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

### Overarching Funds Management Principles

- **Efficiency and effectiveness:** Policy development and operations should take into account, to the extent possible, leading practices of other comparable sovereigns. Regular evaluations should be conducted to ensure the efficiency and effectiveness of the governance framework and borrowing and investing programs.
- **Transparency and accountability:** Information on financial asset and liability management plans, activities and outcomes should be made publicly available in a timely manner. Borrowing costs, investment performance and material exposures to financial risk should be measured, monitored, controlled and regularly reported, as applicable.
- **Risk management:** Risk monitoring and oversight should be independent of financial asset and liability management operations.

### Reserves Management Principles

- **Prudence:** The foreign reserves should be managed to limit exposure to financial risk through the matching of foreign-currency-denominated assets and liabilities, the adherence to prudent investment limits, and the diversification of instruments, currencies and maturities held.
- **Cost-effectiveness:** The reserves investment portfolio should be actively managed such that the net cost to the taxpayer, if any, is minimized.



## Governance of the EFA

### **The Currency Act**

The EFA is governed by the provisions of the *Currency Act*, which allows the Minister of Finance to acquire, borrow, sell or lend assets held in the EFA in accordance with the *Statement of Investment Policy*.

### **Statement of Investment Policy**

The *Statement of Investment Policy* (SIP) sets out the policy governing the acquisition, management and divestiture of assets for the EFA and details the investment objectives, eligible asset classes and currencies, and risk exposure limits. The policy is designed to ensure prudent and effective management practices are followed in accordance with reserves management objectives and principles.

### **Governance Structure**

Responsibility for the management of the EFA is shared between the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, executes transactions for the Account. The strategic planning and the operational management of the EFA are conducted jointly by the two organizations.

The Funds Management Committee (FMC), composed of senior management from the Department of Finance and the Bank of Canada, oversees the management of the EFA and is a decision-making body within limits delegated by the Minister. The Committee advises the Minister on policy and strategy, oversees the implementation of approved policy and plans, reviews performance outcome reports and makes decisions related to the management of the reserves.

The FMC is supported by the Risk Committee (RC), whose mandate is to review and provide opinions on the risk implications of policy proposals and recommendations. The Financial Risk Office at the Bank of Canada provides analytical support to the RC and is responsible for monitoring and regularly reporting on the EFA's financial performance and its exposure to credit, liquidity, market and operational risks.

The FMC is also supported by the Asset-Liability Management Committee (ALMC). In its advisory role on the management of foreign reserves, the ALMC provides recommendations to the FMC on strategic and policy matters and changes to the limits and guidelines established by the Minister of Finance and the FMC. Within limits delegated by the FMC, the ALMC is also a decision-making body, whose decisions are executed by officials at the Bank of Canada and the Department of Finance.

For more information on the governance framework of the EFA, consult the document entitled *Funds Management Governance Framework* at [www.fin.gc.ca/treas/Goveev/TMGF\\_1-eng.asp](http://www.fin.gc.ca/treas/Goveev/TMGF_1-eng.asp).

## **EFA Management Policy**

Management of the EFA follows a set of policies that apply to investments, funding, asset-liability management, risk management and performance measurement.



## Investment Policy

The policy governing the management of EFA assets, set out in the SIP, is designed to achieve the strategic objectives of maintaining a high standard of liquidity, preserving capital value and, subject to those objectives, maximizing return. To achieve these goals, the policy permits a range of investments, notably in US-dollar-, euro- and yen-denominated securities (bonds and bills) issued by sovereigns and their agencies, subnational governments or supranational organizations, including government-guaranteed securities. The policy also permits investment in cash deposits with financial institutions, US-dollar tri-party repurchase agreements (repos), commercial paper and certificates of deposit issued by private sector entities, gold and International Monetary Fund special drawing rights. Lastly, the SIP allows for securities-lending activities to generate incremental returns.

The investment policy splits investments for the EFA into two tiers: the Liquidity Tier and the Investment Tier. The Liquidity Tier serves to meet the core liquidity requirements in foreign currencies and consists of highly rated US-dollar-denominated assets, such as Treasuries, discount notes and overnight bank deposits. The Investment Tier consists of a diversified mix of high credit quality securities denominated in US dollars, euro and yen.

## Swap Management Policy

The swap management policy sets out the framework used to manage the liability structure of the Government's marketable debt by governing the use, procurement and execution of swap agreements. The Government can use swaps to mitigate the risk and/or reduce the cost of borrowing by exchanging interest rate and/or principal payments in one currency for another currency and to change the interest payment characteristics, such as fixed versus floating rates, of borrowings. The policy outlines eligibility criteria for swap counterparties and actual and potential exposure levels to counterparties. A collateral management framework is used to mitigate risk arising from the changes in the mark-to-market value of swap contracts beyond pre-set exposure limits.

## Risk Management Policy

The risk management policy of the EFA requires identifying, monitoring, mitigating, to the extent required, and the regular and timely reporting of treasury risk exposures. Treasury risk includes currency, interest rate, credit, liquidity, legal and operational risks related to the financing and investment of the foreign exchange reserves. For information on recent risk policy initiatives, see the section entitled "Initiatives in 2013–14."

For more information on the risk management policies that pertain to all of the Government's funds management operations, including foreign reserves, cash and debt management, consult the document entitled *Government of Canada Treasury Risk Management Framework* at [www.collectionscanada.gc.ca/webarchives/20071115100942/www.fin.gc.ca/treas/frame/gctrmf06\\_e.html](http://www.collectionscanada.gc.ca/webarchives/20071115100942/www.fin.gc.ca/treas/frame/gctrmf06_e.html).

**Asset-liability management policy:** Foreign currency reserve assets held in the EFA and the foreign currency liabilities and the swaps that finance those assets are managed on a portfolio basis, and are matched as closely as possible in currency and duration, so that the net exposure to currency and interest rate risks is limited.



**Credit risk management policy:** The Department of Finance and the Bank of Canada use a variety of tools to assess and manage credit risk, including an external credit ratings-based framework in which judgment is applied, diversification of credit exposures and the use of collateral frameworks.

**Liquidity risk policy:** Liquidity risk of EFA assets is low due to the high credit quality of eligible investments under the SIP. In addition, liquidity risk is minimized by limiting the portion of the reserve asset portfolio and foreign liabilities that is rolled over at any particular point in time. This ensures that the EFA would be able to meet commitments as they become due under various market conditions.

**Legal and operational risks:** Legal risk associated with agreements and contracts with external parties, including fiscal agents, mandataries and private sector borrowers and lenders, is managed by the Department of Finance. Operational risk is managed by the Bank of Canada and reported on a regular basis.

### Performance Measurement Policy

The EFA's performance measurement policy provides a framework for measuring, analyzing and evaluating the financial performance of EFA investments and associated liabilities. The policy requires regular and timely reporting of the returns on EFA assets and the cost of associated liabilities to senior management within the Department of Finance and the Bank of Canada, the Minister of Finance and Parliament.

**Performance measures:** The principal performance measures are based on accounting information (investment revenues, coupon return and the net carry measure) while asset-liability matching performance is measured using market-based measures such as total return. Liability benchmarks, external indices and attribution analysis are also used to measure portfolio performance. These performance measures are reported on a monthly basis to management at the Department of Finance and the Bank of Canada. For more information on the performance measures, see Annex 4.

**Legislative reporting:** The *Currency Act* requires annual reporting to Parliament on whether the financial performance of the portfolio has resulted in the achievement of the EFA's objectives. The section entitled "Report on Operations in 2013–14" fulfils this requirement.



## Annex 3: Changes in the Level of the Official International Reserves

Unless otherwise noted, in this report the official international reserves are reported in US dollars on a market-value basis.

The level of the official international reserves changes over time due to a variety of factors. As shown in Table A3.1, over the 12-month reporting period the level of reserves increased by \$6,242 million. The increase was due to reserves management operations (\$6,200 million) and currency revaluation effects (\$1,680 million), which was partially offset by return on investments (-\$266 million) and foreign currency debt charges (-\$1,275 million).

**Table A3.1**  
**Sources of Change in Canada's Official International Reserves**  
**Between March 31, 2013 and March 31, 2014**  
market value in millions of US dollars

	Change
Official intervention	-
Net government operations	-98
Reserves management operations	6,200
Gains and losses on gold sales	1
Return on investments	-266
Foreign currency debt charges	-1,275
Revaluation effects	1,680
Other	-
<b>Total change</b>	<b>6,242</b>

### Official Intervention

Official intervention involves buying or selling foreign currencies in exchange for Canadian dollars, and would therefore affect the level of the official international reserves. Intervention in the foreign exchange market for the Canadian dollar might be considered if there were signs of a serious near-term market breakdown (e.g. extreme price volatility with both buyers and sellers increasingly unwilling to transact), indicating a severe lack of liquidity in the Canadian-dollar market. It might also be considered if extreme currency movements seriously threatened the conditions that support sustainable long-term growth of the Canadian economy. The goal would be to help stabilize the currency and to signal a commitment to back up the intervention with further policy actions, as necessary.

Since September 1998, the Bank of Canada has not undertaken any foreign exchange market intervention in the form of either purchases or sales of US dollars versus the Canadian dollar.<sup>10</sup>

<sup>10</sup> Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.



Table A3.2

### Official Intervention

millions of US dollars

	2006-07	2007-08	2008-09	2009-10	2010-111	2011-12	2012-13	2013-14
Purchases	-	-	-	-	-124	-	-	-
Sales	-	-	-	-	-	-	-	-
<b>Net</b>	-	-	-	-	-124	-	-	-

### Net Government Operations

The net purchase of foreign currencies for government foreign exchange requirements and for additions to reserves totalled -\$98 million. These transactions offset the repayment of three IMF loans to the EFA.

### Reserves Management Operations

The purchase and sale of foreign currency assets along with the issuance and maturity of debt used to fund those assets totalled \$6.2 billion. Over the reporting period, funds raised through the issuance of bonds, foreign exchange (FX) swaps, cross-currency swaps, medium-term notes and Canada bills, totalling \$16.7 billion, exceeded debt maturities totalling \$10.5 billion (including Canada bill maturities of \$6.4 billion, FX swap maturities of \$0.6 billion and cross-currency swap maturities of \$3.4 billion).

### Gains and Losses on Gold Sales

This factor reflects the gains or losses on sales of gold which are the difference between the proceeds of the sales and the market value of gold sold. Sales of gold coins resulted in a \$1-million gain on a market-value basis.

### Return on Investments

Return on investments comprises interest earned on investments (\$1.19 billion) and the decrease in the market value of securities resulting from changes in interest rates (\$1.46 billion). The overall effect on the official international reserves was a net decrease of \$266 million.

### Foreign Currency Debt Charges

Foreign currency debt charges reduced the level of the official international reserves by \$1.275 billion. These expenses are charged to the Consolidated Revenue Fund but paid using foreign assets of the EFA.

### Revaluation Effects

Revaluation effects resulting from movements in exchange rates and gold market rates reflect changes in the market value of the official international reserves. Revaluation effects increased the official international reserves by \$1.68 billion, primarily due to the appreciation of the euro versus the US dollar during the reporting period.



## International Monetary Fund Reserve Position

Each member country of the International Monetary Fund (IMF) is assigned a quota that represents the maximum amount of resources that it is obliged to provide to the IMF, upon request. As well, the IMF typically has on deposit with each government holdings in the form of non-interest-bearing notes and non-interest-bearing accounts. Canada's reserve position at the IMF represents the difference between Canada's quota and the IMF's holdings of Canadian dollars, which is equivalent to the cumulative amount of all the money that Canada has advanced to the IMF over the years.

Canada's reserve position at the IMF is an asset that is included as a component of the official international reserves but is not held in the EFA. As such, changes in Canada's reserve position that may result from advances, repayments or revaluations directly impact the Government of Canada's consolidated financial statements. During 2013–14, the reserve position increased modestly over the previous fiscal year.

More detailed information on monthly levels and changes in Canada's official international reserves is provided in Tables A3.3 and A3.4.

Table A3.3

### Canada's Official International Reserves

#### Month-to-Month Changes

market value in millions of US dollars

Month-end	Securities	Deposits	Gold	Special drawing rights	Reserve position in the IMF	Total	Total monthly change
<b>2013</b>							
March	56,782	331	165	8,534	4,396	70,208	850
<b>2013-14</b>							
April	57,444	1,042	150	8,594	4,405	71,635	1,427
May	54,773	2,882	142	8,499	4,399	70,695	-940
June	55,215	509	121	8,528	4,513	68,886	-1,809
July	55,865	593	133	8,571	4,595	69,757	871
August	56,084	521	139	8,583	4,601	69,928	171
September	57,235	611	130	8,641	4,775	71,392	1,464
October	57,378	595	130	8,663	4,731	71,497	105
November	58,049	616	122	8,648	4,603	72,038	541
December	57,457	973	115	8,675	4,717	71,937	-101
January	58,345	983	120	8,642	4,688	72,778	841
February	63,071	650	127	8,718	4,603	77,169	4,391
March	62,394	612	124	8,709	4,611	76,450	-719
<b>Total</b>	n/a	n/a	n/a	n/a	n/a	n/a	6,242

*Official International Reserves*



Table A3.4

**Canada's Official International Reserves****Details of Month-to-Month Changes**

market value in millions of US dollars

Month-end	Reserves management operations	Gains and losses on gold sales	Return on investments	Foreign currency debt charges	Revaluation effects	Net government operations	Official intervention	Other transactions	Total monthly change
<b>2013</b>									
March	1,267	1	179	108	-489	0	0	0	850
<b>2013–14</b>									
April	605	1	308	-63	576	0	0	0	1,427
May	125	0	-598	-78	-350	-39	0	0	-940
June	-1,070	0	-546	-252	60	0	0	-1	-1,809
July	408	0	104	-111	480	-10	0	0	871
August	632	0	-277	-93	-91	0	0	0	171
September	679	0	382	-124	576	-49	0	0	1,464
October	-209	0	278	-67	102	0	0	1	105
November	681	0	-30	-76	-34	0	0	0	541
December	120	0	-432	-81	293	0	0	-1	-101
January	849	0	564	-139	-434	0	0	1	841
February	3,826	0	81	-76	560	0	0	0	4,391
March	-446	0	-100	-115	-58	0	0	0	-719
<b>Total</b>	<b>6,200</b>	<b>1</b>	<b>-266</b>	<b>-1,275</b>	<b>1,680</b>	<b>-98</b>	<b>0</b>	<b>0</b>	<b>6,242</b>

*Official International Reserves*



## Annex 4: Detailed Portfolio Performance

Unless otherwise noted, in this report the official international reserves are reported in US dollars on a market-value basis.

This annex provides detailed technical information on indicators used to measure the portfolio's performance in four areas: 1) revenues; 2) net return on assets; 3) cost of advances to the EFA; and 4) market and credit risk measures.

### 1) Revenues

Revenues include income from investments and foreign exchange gains. Data are reported in Canadian dollars, as EFA revenues are reported in Canadian dollars in the attached financial statements. In 2013–14, income totalled C\$1.51 billion compared to C\$1.40 billion in 2012–13. The main categories of income are summarized in Table A4.1.

Table A4.1

#### Revenues of the Exchange Fund Account

millions of Canadian dollars

	April 1, 2013 to March 31, 2014	April 1, 2012 to March 31, 2013
<b>Net revenue from investments</b>		
Marketable securities	1,423	1,492
Cash and cash equivalents	1	1
Special drawing rights	8	8
Gains on sale of gold <sup>1</sup>	12	13
Total net revenue from investments	1,444	1,514
<b>Other income</b>		
Net foreign exchange gain/loss	61	-113
<b>Net revenue</b>	1,505	1,401

### 2) Net Return on Assets

The net return on assets of the EFA is reported using two separate measures. The first is called "carry" and represents the net revenue generated by funding and holding reserve assets from a cash only perspective (i.e., interest paid and received and realized gains or losses). The second measure is called "total return." It represents the net return generated by the EFA by including the cash flows used in the carry measure, as well as the changes in the market values of the assets and liabilities over the reporting period. By including the market or fair values of the EFA's assets and corresponding liabilities, the total return measure includes unrealized gains or losses, which is the difference between what an asset (or liability) is worth compared to what it cost.



## Carry

Carry represents the interest received on the EFA's assets minus the interest paid on the liabilities that fund the assets. The carry measure is also reported including any realized gains or losses stemming from asset sales, which is the difference between the amount for which an asset is sold and the amount it originally cost.

Table A4.2 provides an estimate of the carry for the EFA and its constituent currency portfolios. The carry for the 2013–14 fiscal year is estimated at -24 basis points, a 6-basis-point difference over 2012–13. The deterioration was mainly the result of the purchase of new assets with lower coupons to replace assets with higher coupons. As assets and liabilities with high coupons mature, they are being replaced with new lower-yielding instruments that do not provide the same positive carry of assets over liabilities as was experienced in the past.

Taking into account gains or losses on the sale of assets during 2013–14, the EFA incurred net gains of \$95 million, or 25 basis points. These sales resulted in a realized gain of \$282 million and a net loss in interest income of \$187 million. The EFA realized \$118 million in gains on US asset sales and \$164 million in gains on euro asset sales.

Table A4.2

### Carry of the Official International Reserves<sup>1,2</sup>

	April 1, 2013 to March 31, 2014				April 1, 2012 to March 31, 2013		
	Interest earned on assets (millions of US dollars)	Interest paid on liabilities (millions of US dollars)	Net interest earned on assets (millions of US dollars)	Carry (basis points)	Carry (including net realized gains) (basis points)	Carry (basis points)	Carry (including net realized gains) (basis points)
Euro portfolio	442.7	535.8	-93.1	-12.7	16.1	-13.7	32.4
GBP portfolio	0.1	0.1	0	0	0	0	0
Yen portfolio	1.1	-0.4	1.5	0.3	0.3	0.2	0.2
US\$ portfolio	638.3	732.8	-94.5	-11.6	9.1	-4.7	26.6
<b>Total carry<sup>3</sup></b>	<b>1,082.1</b>	<b>1,268.2</b>	<b>-186.1</b>	<b>-24.0</b>	<b>25.5</b>	<b>-18.2</b>	<b>59.3</b>



## Total Return on a Market-Value Basis

The total return measure is used in several different ways. It is used to compare the performance of the EFA's assets to its liabilities in order to depict the net return of the portfolio on a market-value basis. It is also compared to an external benchmark index in order to provide an independent measure of the performance of the EFA and to enhance the understanding of performance in relation to broader market developments. Lastly, the EFA's total return is decomposed into the key sources of return. This is done by decomposing the total return measures for both the assets and liabilities through a technique called "performance attribution." Performance attribution allows management to discern what aspects of total return resulted from controllable influences as compared to those sources that are market-driven. As well, the attribution analysis provides an indication as to how well objectives of the asset-liability management framework of the EFA are being met.

Table A4.3 provides an estimate of the total return on a market-value basis for the EFA as a whole and its key portfolios compared to the corresponding liabilities. The total return was 71 basis points, or a gain of \$406 million, in the fiscal year ending March 31, 2014, compared to 95 basis points, or a gain of \$532 million, in the year ending March 31, 2013. This reflects net returns in US-dollar terms of 39 basis points for the US-dollar portfolio, 142 basis points for the euro portfolio and 111 basis points for the yen portfolio. The positive net total return was caused by credit spread improvement, particularly in the euro portfolio. These numbers include interest flows as well as all gains or losses earned over the period, regardless of whether they were realized or not.

Table A4.3

**Total Return of the EFA Compared to Liability Benchmarks**

	April 1, 2013 to March 31, 2014			April 1, 2012 to March 31, 2013	
	US\$ portfolio	Euro portfolio	Yen portfolio	Total EFA	Total EFA
<b>EFA asset portfolio</b>					
Return in original currency	-1.12%	0.89%	-0.04%	n/a	n/a
Return in US\$ (A)	-1.12%	8.42%	-8.84%	1.82%	2.17%
<b>Liability benchmarks</b>					
Return in original currency	-1.51%	-0.43%	-1.26%	n/a	n/a
Return in US\$ (B)	-1.51%	7.00%	-9.95%	1.11%	1.22%
<b>Return vs. liability benchmark in basis points (A - B) in US\$</b>	39	142	111	71	95



Table A4.4 compares the total return of the EFA to a set of Merrill Lynch government securities indices.<sup>11</sup> This provides some insight into how the total return of the EFA compares to a portfolio invested solely in US Treasury and German government securities. While the indices have been combined and weighted to reflect the currency composition and duration of the EFA, they only provide a general indication of its performance because the EFA is invested in a broader range of high quality assets. In the fiscal year ending March 31, 2014, the EFA's total return was higher than the return on the external indices by 30 basis points. This was due to the US Treasury and German government securities in the external indices underperforming the more diversified holdings in the EFA. The EFA's total return was higher than the external indices by 95 basis points in the fiscal year ending March 31, 2013.

Table A4.4

**Total Return of the EFA Compared to External Indices<sup>1,2,3</sup>****April 1, 2013 to March 31, 2014**

	US\$ portfolio	Euro portfolio	Yen portfolio	Total EFA
<b>EFA asset portfolio</b>				
Return in original currency (A)	-1.12%	0.89%	-0.04%	n/a
Return in US\$	-1.12%	8.42%	-8.84%	1.82%
<b>External indices</b>				
Return in original currency (B)	-1.22%	0.25%		n/a
Return in US\$	-1.22%	7.73%	n/a	1.52%
<b>Return vs. external indices in basis points (A – B) in original currency<sup>4</sup></b>				
	10	64	n/a	30

**Performance Attribution of Total Return**

Table A4.5 summarizes the attribution results for the EFA's US-dollar and euro portfolios for the fiscal year ending March 31, 2014. Total return is decomposed into four underlying return factors: coupon and amortization, changes in credit spreads, changes in interest rates and securities-lending activities. For 2013–14, the attribution results indicate that the coupon and amortization effect and credit spread effect contributed positively to portfolio returns, resulting in an overall positive total return for the portfolio.

The coupon effect (the difference between the yield to maturity of reserve assets and liabilities issued to fund the assets) contributed positively to total return. The coupon effect generally represents the underlying return of the portfolio if matched assets and liabilities are held to maturity.

<sup>11</sup> Merrill Lynch, used with permission. "MERRILL LYNCH IS LICENSING THE MERRILL LYNCH INDICES 'AS IS,' MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE QUALITY, ACCURACY AND/OR COMPLETENESS OF THE MERRILL LYNCH INDICES OR ANY DATA INCLUDED THEREIN OR DERIVED THEREFROM, AND ASSUMES NO LIABILITY IN CONNECTION WITH THEIR USE."



The credit spread effect (the difference between the change in the market value of EFA assets and the foreign liabilities due to changes in the credit quality of EFA issuers and Canada) was the main driver of the positive total return in the EFA's portfolio. Changes in the credit spreads of assets were more than offset by changes in the credit spreads of existing liabilities, notably in the euro portfolio, resulting in an overall positive credit impact on the EFA. The credit spread effect is transitory to the extent that assets are held to maturity.

The yield curve effect (the impact of changes in the general level of interest rates) demonstrates the extent to which the EFA's assets and liabilities are matched in terms of their sensitivity to changes in interest rates. Although total returns for both the US-dollar and euro asset portfolios were significantly affected by yield curve movements over the period, similar effects were observed in the corresponding liabilities. This demonstrates the benefit of the asset-liability management framework of the EFA over the reporting period.

As well, a component of the total return is generated through securities-lending activities. Any difference between the actual return and the sum of the above effects is the residual return, which reflects the fact that performance attribution approximately explains total return.

Table A4.5

**Performance Attribution for the US-Dollar and Euro Portfolios Compared to Liability Benchmarks**

**April 1, 2013 to March 31, 2014<sup>1,2,3</sup>**

per cent

	US\$ portfolio			Euro portfolio		
	Assets	Liabilities	Difference	Assets	Liabilities	Difference
Coupon effect	0.93	0.77	0.16	0.82	0.47	0.35
Yield curve effect	-1.76	-1.90	0.14	0.43	0.46	-0.03
Credit spread effect	-0.28	-0.47	0.19	-0.35	-1.34	0.99
Securities-lending activities	0.00					
Residual return	-0.02	0.08	-0.10	-0.01	-0.01	0.01
Return in original currency	-1.12	-1.51	0.39	0.89	-0.43	1.32
Exchange rate effect				7.53	7.43	0.10
<b>Total return in US\$<sup>4</sup></b>	<b>-1.12</b>	<b>-1.51</b>	<b>0.39</b>	<b>8.42</b>	<b>7.00</b>	<b>1.42</b>



### 3) Notional Cost of Advances to the EFA

#### From the Consolidated Revenue Fund

The cost of advances represents an estimate of the cost of maintaining the EFA by adding the cost of foreign debt payments (including the interest on cross-currency swaps) to the notional amount of foreign interest that would be paid on non-interest-bearing items or items funded in Canadian dollars. The EFA is a stand-alone account of assets while foreign liabilities are paid out of the Consolidated Revenue Fund (CRF). EFA advances represent funds (liabilities) from the CRF in support of maintaining the EFA. The level of foreign currency advances, measured in Canadian dollars, varies with the flow of foreign currencies between the EFA and the CRF.

**Actual foreign interest charges:** The proceeds from foreign currency borrowings are remitted to the CRF and concurrently advanced to the EFA. Foreign debt interest and principal repayments are charged to the CRF but are paid using the foreign assets of the EFA, reducing the amount advanced to the EFA. Actual foreign interest paid is converted into Canadian currency for the purpose of determining this portion of the notional cost of advances; for 2013–14, this value was C\$1,367.4 million.

**Notional interest charged in Canadian dollars:** Because domestically funded EFA assets, SDR advances, and the portion of net revenues reinvested in the EFA (i.e., cumulative net revenues of the EFA less cumulative foreign debt interest payments) are not linked to foreign liabilities, an imputed interest cost is used to approximate the notional interest charge on the portion of advances from the CRF related to those assets. For 2013–14, a weighted cost of domestic and foreign funding (2.37 per cent) was used in calculating notional interest paid in Canadian dollars, resulting in a value of C\$159.6 million.

### 4) Risk Measures

The risk management framework covers market, credit, liquidity, legal and operational risks related to the financing and investment of the foreign reserves. Risk measures are reported on a monthly basis to management at the Department of Finance and the Bank of Canada.

#### Market Risk

Market risk stems from changes in interest rates and exchange rates. Several industry-standard measures of market risk exposure are employed: scenario analysis, stress testing and Value at Risk (VaR) (Table A4.6). Stress testing and scenario analysis are used to evaluate the portfolio's performance under extraordinary circumstances in the market. VaR is a statistical measure for estimating potential losses to the EFA portfolio arising from extreme but plausible market movements such as changes in interest and exchange rates.

Stress tests are regularly carried out to gauge the sensitivity of the EFA portfolio to large changes in exchange rates and interest rates, including the portfolio impact of a 1-per-cent depreciation of the euro and yen vis-à-vis the US dollar and a 1-per-cent increase in interest rates across the yield curve. The results showed that, on a net basis during the reporting period, the EFA assets and the associated liabilities had very minimal exposure to currency depreciations and upward shifts in the yield curve.



In addition, some hypothetical scenario analyses that mimic market conditions during four previous extraordinary market events were regularly conducted: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management (LTCM) collapse; and the 2001 US terrorist attacks. The scenario analyses showed that the EFA would generally perform well during such periods of market turbulence. The March 31, 2014 results were broadly in line with those reported for March 31, 2013. Scenario creation is a dynamic process. New scenarios continue to be considered and will be added when relevant and feasible.

Market VaR is a statistical measure that estimates the possible loss in portfolio value within a specific time period during normal market conditions as a result of interest rate and exchange rate changes. This is regularly reported for the entire EFA portfolio and on the net position between assets and liabilities. As of March 31, 2014, the EFA had a 99-per-cent 10-day VaR of \$15 million, which implied that 99 per cent of the time, the value of the portfolio was not expected to decline by more than \$15 million, on a net basis, over a 10-trading-day period.

It should also be noted that the Market VaR measure does not include either credit risk or the spread risks inherent in the cross-currency swap funding, and therefore underestimates the total risk of the EFA. As a result of the asset allocation framework review, work has begun on a Total Market VaR metric that will ameliorate the Market VaR measure shortcomings.

**Table A4.6**  
**Market Risk Measures**  
millions of US dollars

	March 31, 2014		March 31, 2013	
	EFA	EFA assets less liabilities	EFA	EFA assets less liabilities
<b>Single factor stress tests</b>				
1% depreciation of euro/yen	-196	-3	-189	-1
1% upward parallel shift in yield curve	-2,032	2	-2,237	15
<b>Scenario analyses</b>				
1994 Fed tightening	-5,140	68	-5,506	100
1997 Asian financial crisis	-795	180	-753	183
1998 Russian default/LTCM collapse	-702	329	-586	328
2001 terrorist attacks	1,813	188	1,804	172
<b>99% 10-day VaR</b>	<b>1,104</b>	<b>15</b>	<b>762</b>	<b>14</b>

### Credit Risk

Credit risk includes the risk that a counterparty or issuer will be unable or unwilling to meet their obligations to pay as well as the risk that the value of an instrument will change as a result of actual or perceived changes in the credit quality of a counterparty or issuer.



Credit risk, which is the most important risk faced by the EFA, is controlled by setting limits on both actual and potential exposures to counterparties and issuers. A collateral management framework is used for managing the credit risk to financial institution counterparties arising from the cross-currency swaps used to fund the EFA. Under this framework, high quality collateral is placed with collateral managers for the EFA when the market value of the swap contracts exceeds specified thresholds. The Credit VaR model and some selected credit risk stress tests were used to measure the EFA's exposure to credit risk during the reporting period (Table A4.7). However, the Credit VaR estimate does not capture the market risk effect of cross-currency funding and therefore does not reflect the total risk of the EFA.

Table A4.7

**Credit Risk Measures**

millions of US dollars

	March 31, 2014	March 31, 2013
<b>Credit VaR and expected shortfall</b>		
99.9% 365-day Credit VaR	1,756	2,014
Expected shortfall	4,637	4,188
<b>Stress test</b>		
Potential loss if counterparties with negative outlook or negative watch are downgraded one notch	112.3	192.3

The Credit VaR model provides an estimate of the maximum potential loss in portfolio value within a year as a result of a credit event, such as the downgrade or default of counterparties, under normal market conditions. As of March 31, 2014, the EFA had a 99.9-per-cent 1-year Credit VaR of \$1.8 billion, which implied that 99.9 per cent of the time, the value of the portfolio was not expected to decline by more than \$1.8 billion over a 1-year period due to credit events. The decrease in Credit VaR from the previous year reflects tighter credit spreads, which decrease the possible losses associated with downgrades and defaults. An associated measure, expected shortfall, computes the expected average loss in portfolio value during a 1-year period due to an extreme, unexpected credit event, whose possibility of happening (less than 0.1 per cent) was not captured by the Credit VaR statistic. The expected shortfall measure for the EFA was \$4.6 billion as of March 31, 2014.

Credit risk stress tests were also carried out to evaluate potential losses to the EFA assets and the associated liabilities arising from extraordinary credit events in the market. These tests subjected the EFA to hypothetical scenarios, such as all counterparties with a negative outlook being downgraded by one notch. The difference between this year and last is mainly attributed to changes in the level of credit spreads and the introduction of a new source for the credit spread data. As a result, the potential loss to the EFA under this hypothetical scenario has decreased compared to the previous fiscal year.



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## Annex 5: List of Agents and Mandataries as Defined by the *Currency Act*

The *Currency Act* stipulates that this report include a list of the following agents and mandataries appointed by the Minister under subsection 17.2(3) of the Act to perform services concerning the EFA.

### **Bank of Canada**

The Bank of Canada, as specified under the *Bank of Canada Act*, is the fiscal agent for the Government of Canada. As part of its fiscal agency responsibilities, the Bank manages the Government's foreign exchange reserves.

### **RBC Investor Services Trust and State Street Corporation**

RBC Investor Services Trust (formerly RBC Dexia Investor Services) and State Street Corporation manage the securities-lending program for the EFA. As the Government's agents and mandataries, they carry out securities lending on behalf of the Government. The program involves loaning a security from the Government to a counterparty, who must eventually return the same security, in order to earn additional return on the portfolio.



## Annex 6: Glossary

**basis point:** One-hundredth of a percentage point (0.01 per cent).

**Canada bill:** Promissory note denominated in US dollars and issued only in book-entry form. Canada bills mature not more than 270 days from their date of issue, and are discount obligations with a minimum order size of US\$1,000,000 and a minimum denomination of US\$1,000. Delivery and payment occur in same-day funds through JP Morgan Chase Bank in New York City. Primary distribution occurs through four dealers: CIBC World Markets, Credit Suisse First Boston LLC, Goldman, Sachs & Co. and RBC Dominion Securities Inc. Rates on Canada bills are posted daily for terms of one to six months. Canada bills are issued for foreign exchange reserve funding purposes only.

**Canada note:** Promissory note usually denominated in US dollars and available in book-entry form. Canada notes are issued in denominations of US\$1,000 and integral multiples thereof. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. The interest rate or interest rate formula, issue price, stated maturity, redemption or repayment provisions, and any other terms are established by the Government of Canada at the time of issuance of the notes and are indicated in the Pricing Supplement. Delivery and payment occur through Citibank, N.A. The Government may also sell notes to other dealers or directly to investors. Canada notes are issued for foreign exchange reserve funding purposes only.

**certificate of deposit:** Promissory note issued by a bank. It is a time deposit that restricts holders from withdrawing funds on demand. Although it is still possible to withdraw the money, this action will often incur a penalty.

**commercial paper:** Senior level unsecured short-term debt that is a source of cost-effective short-term financing available to the largest and most creditworthy issuers relative to bank loans.

**cross-currency swap:** An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

**euro medium-term note (EMTN):** Medium-term note issued outside the United States and Canada. Government of Canada EMTNs are sold through TD Securities or by other dealers who are acting as the Government's agent for the particular transaction. The arranger for the EMTN program is TD Securities. The maturities of EMTNs are not fixed, and can range from short- to long-term. Notes issued under this program can be denominated in a range of currencies and structured to meet investor demand. EMTNs are issued for foreign exchange reserve funding purposes only.

**global bond:** Syndicated, marketable debt instrument issued in a foreign currency with a fixed interest rate. The majority of global bonds issued by Canada are denominated in US dollars. Global bonds are issued for foreign exchange reserve funding purposes only.

**repurchase agreement (repo):** Repos are transactions in which one party sells securities to another while agreeing to repurchase those same securities at a pre-specified price on a predetermined future date. These transactions are similar to secured loans where the lender receives securities as collateral for protection against default risk. The collateral is marked-to-market with appropriate haircuts to protect the Government from market risk in collateral values.



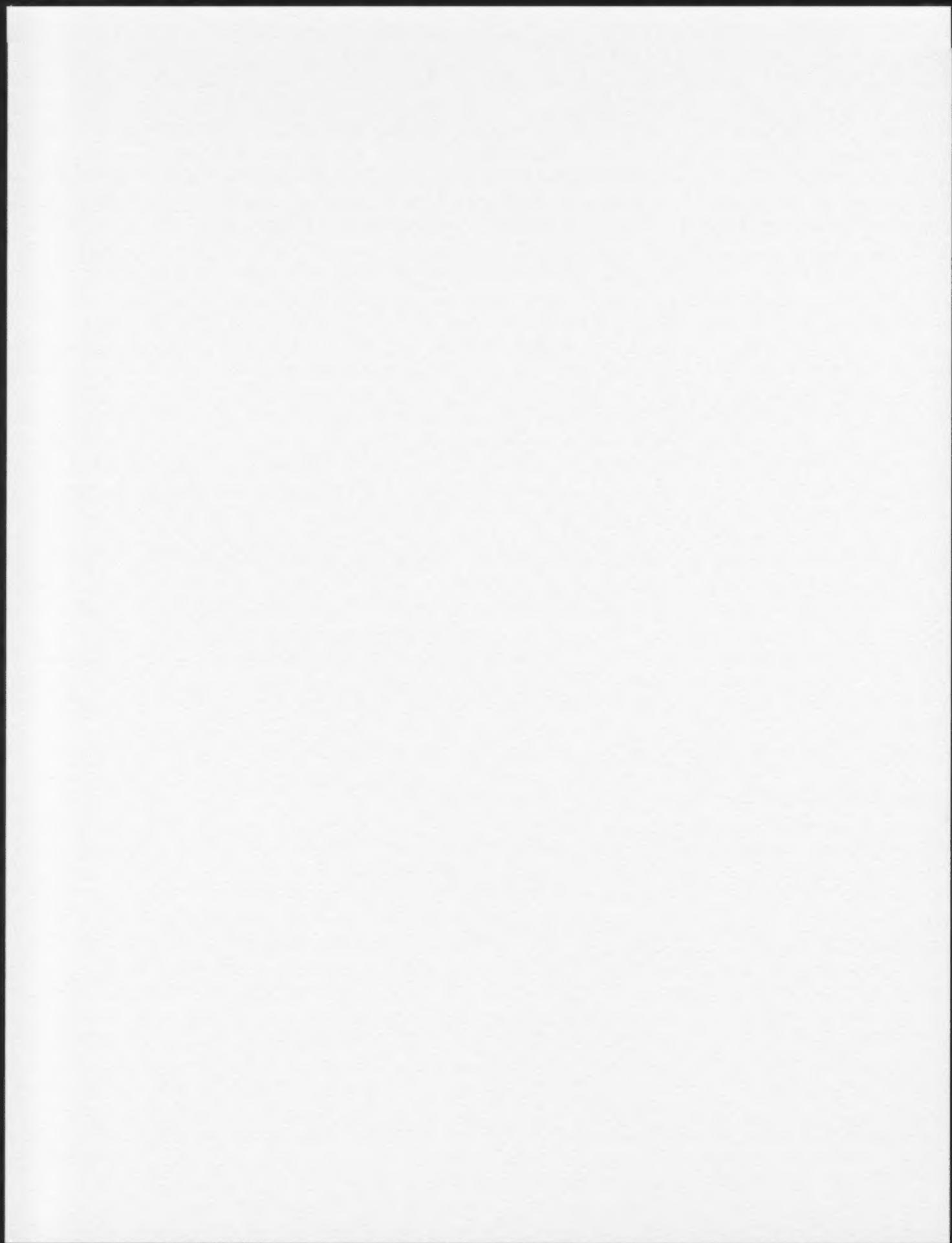
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**securities lending:** A loan of a security from one counterparty to another, who must eventually return the same security as repayment. The loan is collateralized by other high quality securities. Securities lending allows a counterparty in possession of a particular security to earn enhanced returns on the security.

**special drawing right (SDR):** An international reserve asset created by the International Monetary Fund (IMF) in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of international currencies.

**Exchange Fund Account  
Unaudited Statement of Financial Position  
and Statement of Operations**

Year Ended 31 March 2014





## Exchange Fund Account

### Statement of Financial Position

**As at 31 March**

(in millions of Canadian dollars)

	2014	2013
<b>Financial Assets</b>		
Cash and cash equivalents (notes 2, 3)	677	337
Investments (note 2)	67,054	54,368
Marketable securities (note 3)	9,628	8,671
Special drawing rights (note 3)	6	6
Gold (note 3)	76,688	63,045
Total investments	77,365	63,382
Total financial assets	77,365	63,382
<b>Liabilities</b>		
Due to the Consolidated Revenue Fund (note 4)	77,365	63,382

Paul Rochon  
Deputy Minister  
Department of Finance

Randy Larkin, CPA, CMA  
Chief Financial Officer  
Department of Finance



## Exchange Fund Account

### Statement of Operations For the Year Ended 31 March (in millions of Canadian dollars)

	2014	2013
<b>Net revenue from investments</b>		
Marketable securities		
Interest	1,130	1,091
Gains on sales of marketable securities	294	404
Transaction costs and other	(1)	(3)
Interest on cash and cash equivalents	1	1
Interest on special drawing rights	8	8
Gains on sales of gold	12	13
Total net revenue from investments	<b>1,444</b>	<b>1,514</b>
<b>Other</b>		
Net foreign exchange gain (loss)	<b>61</b>	<b>(113)</b>
<b>Net revenue for the year (note 2)</b>	<b>1,505</b>	<b>1,401</b>



# Exchange Fund Account

## Notes to the Statements For the Year Ended 31 March 2014

### 1. Authority and Objectives

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar. The Minister of Finance empowers the Account to acquire or sell assets deemed appropriate for this purpose, in accordance with the Account's *Statement of Investment Policy*.

Assets held in the Account are managed to provide foreign currency liquidity to the government and to promote orderly conditions for the Canadian dollar in foreign exchange markets, if required. Canada's current policy is to intervene in foreign exchange markets on a discretionary, rather than a systematic, basis and only in the most exceptional of circumstances. Since September 1998, no transactions have been aimed at moderating movements in the value of Canadian dollar.

In accordance with the *Currency Act*, the net revenue for the year is paid to or charged to the Consolidated Revenue Fund (CRF) of the Government of Canada within three months after the end of the fiscal year, and the Minister of Finance reports to Parliament on the operations of the Account within the first 60 days on which Parliament is sitting after the end of the fiscal year. These statements have been prepared by the Department of Finance.

### 2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in a manner consistent with the accounting policies used by the Government of Canada to prepare its financial statements.

#### a) Revenue recognition

Revenue from investments is recognized on an accrual basis and includes interest earned, the amortization of premiums and discounts using the straight-line method, gains or losses on sales of securities and on sales of gold, and revenues from securities lending activities. Interest is accrued on short-term deposits, deposits held under repurchase agreements, marketable securities, and special drawing rights (SDRs).

#### b) Expense recognition

The Account's administrative, custodial, and fiscal agency services are provided and paid for by the Bank of Canada and the Department of Finance. These costs have not been recognized in the Statements.

In addition, the notional cost of the funding of the Account's assets and advances from the CRF are not recognized in the Statements.



### **c) Financial assets**

#### **Cash and cash equivalents**

Cash and cash equivalents consists of cash and short-term deposits. Short-term deposits are measured at cost and are generally held to maturity. The resulting revenue is included in interest from cash and cash equivalents.

#### **Deposits held under repurchase agreements**

Deposits held under repurchase agreements are measured at cost. The resulting revenue is included in income from marketable securities. At the reporting date, and in the prior year, the Account did not hold deposits held under repurchase agreements.

#### **Marketable securities**

Purchases and sales of securities are recognized at the settlement dates. Marketable securities are measured at cost and are adjusted for amortization of purchase discounts and premiums on a straight-line basis over the term to maturity of the security. The carrying value of marketable securities includes accrued interest.

On de-recognition of a financial asset measured at amortized cost, the difference between the asset's carrying amount and the sum of the consideration received and receivable is recognized in net revenue.

Short-term deposits, deposits held under repurchase agreements and marketable securities are written down to their recoverable amount in the event of an other-than-temporary impairment in value.

Writions to reflect other-than-temporary impairment are recognized in *Total net revenue from investments* in the Statement of Operations.

#### **Securities lending program**

Under the securities lending program, the Account has agency agreements with two major financial institutions. Loans of securities are effected on behalf of the Account by these agents, who guarantee the loans and obtain collateral of equal or greater value from approved counterparties. These transactions can range from 1 to 31 days in duration. The securities loaned continue to be accounted for as investment assets. Income on securities lending transactions is included in *Total net revenue from investments* in the Statement of Operations.

#### **Special drawing rights**

The SDR serves as the unit of account for the International Monetary Fund (IMF) and its value is based on a "basket" of four major currencies: the euro, U.S. dollar, the pound sterling and the Japanese yen.

SDRs are initially recognized at cost and are subsequently remeasured at each reporting date in Canadian dollars at market exchange rates.

#### **Gold**

Gold is carried in the Account at a value of 35 SDRs per fine ounce.



### Translation of foreign currencies and special drawing rights

Assets denominated in foreign currencies and SDRs are translated into Canadian-dollar equivalents at the rates prevailing as of the date of the Statements, which were as follows:

	2014	2013
U.S. dollars	<b>1.1055</b>	1.0160
Euro	<b>1.5230</b>	1.3024
Japanese yen	<b>0.0107</b>	0.0108
British pound sterling	<b>1.8430</b>	—
SDRs	<b>1.7087</b>	1.5220

Gains or losses resulting from the translation of assets and advances from the CRF denominated in foreign currencies and SDRs, as well as from transactions throughout the fiscal year, are recognized as net foreign exchange gains or losses and are included in the Statement of Operations.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

#### *d) Use of estimates and measurement uncertainty*

The preparation of the Statements requires management to make estimates and assumptions based on information available as of the date of the Statements. Significant estimates are primarily in the area of the fair values of financial instruments, including any impairment (note 3).



### 3. Financial Instruments

#### Fair value of financial assets

(in millions of Canadian dollars)

	31 March 2014		31 March 2013	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Cash and cash equivalents</b>				
U.S. dollar	<b>391</b>	<b>391</b>	313	313
Euros	<b>51</b>	<b>51</b>	16	16
Japanese yen	<b>10</b>	<b>10</b>	8	8
British pound sterling	<b>2</b>	<b>2</b>	—	—
<b>Short-term deposits</b>	<b>223</b>	<b>223</b>		
<b>Total cash and cash equivalents</b>	<b>677</b>	<b>677</b>	337	337
<b>Investments</b>				
Marketable securities				
U.S. dollar	<b>46,636</b>	<b>47,423</b>	36,599	38,553
Euros	<b>19,903</b>	<b>21,037</b>	17,462	18,830
Japanese yen	<b>316</b>	<b>318</b>	307	308
British pound sterling	<b>199</b>	<b>198</b>	—	—
<b>Total marketable securities</b>	<b>67,054</b>	<b>68,976</b>	54,368	57,691
SDRs	<b>9,628</b>	<b>9,628</b>	8,671	8,671
Gold	<b>6</b>	<b>137</b>	6	167
<b>Total investments</b>	<b>76,688</b>	<b>78,741</b>	63,045	66,529
<b>Total financial assets</b>	<b>77,365</b>	<b>79,418</b>	63,382	66,866

The estimated fair value of cash and cash equivalents approximates their carrying value, given their short term to maturity.

The estimated fair values of marketable securities are based on quoted market prices and include accrued interest. If such prices are not available, the fair value is determined by discounting future cash flows using an appropriate yield curve. During the year, and in the prior year, no marketable securities were written down to reflect other-than-temporary impairment in value.

Since SDRs are translated into Canadian-dollar equivalents at the rates prevailing at the Statement date, the carrying value approximates fair value on the reporting date.

The estimated fair value of gold is based on the London gold fixing of \$1,428.03 at 31 March 2014 (\$1,623.82 at 31 March 2013) per fine ounce.

#### Credit risk

Credit risk is the risk that a counterparty to a financial contract will cause a loss to the Account by failing to discharge its obligations in accordance with agreed upon terms.



To ensure that the Account's asset portfolio is prudently diversified with respect to credit risk, the *Statement of Investment Policy* prescribed by the Minister of Finance specifies limits on holdings by class of issuer (sovereign, agency, supranational, corporation or commercial financial institution), by any one issuer or counterparty, and by type of instruments. The *Statement of Investment Policy* also specifies the treatment of holdings that do not meet eligibility criteria or limits due to exceptional circumstances such as ratings downgrades.

With respect to the *Statement of Investment Policy*, the Account may hold fixed income securities of highly rated sovereigns, central banks, government-supported entities and supranational organizations. To be eligible for investment, an entity must have a credit rating in the top seven categories from two of four designated rating agencies (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Service). The Account may also make deposits and execute other transactions, up to prescribed limits, with commercial financial institutions that meet the same rating criteria.

As stipulated in the *Currency Act*, the Minister may appoint agents to perform services concerning the Account. Through the securities lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of approved counterparties. Each borrower must enter into a Securities Loan Agreement with at least one of the agents. Borrowers are also required to provide collateral for securities borrowed, according to a specific list approved by the Government. Collateral is limited to specific security types, terms to maturity, and credit ratings.

The agents also provide an indemnity in the event of default by the borrower. The Account enters into securities lending transactions in order to increase its return on investments.

#### **Market risk**

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk comprises three types of risk: interest rate risk, currency risk, and other price risk. Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in market interest rates. Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices, other than those arising from interest rate risk or currency risk. The Account is not exposed to significant other price risk.

Interest rate and currency risks are managed, with due consideration of the risk to the Government of Canada, through the asset-liability management policy. This policy utilizes a strategy of matching the duration structure and the currency of the Account's assets with the foreign currency borrowings of the Government of Canada that notionally finance the Account's assets. Other price risks are mitigated by holding high quality liquid assets.

#### **Liquidity risk**

Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities. Liquidity risk is minimized by limiting the portion of the Government of Canada's foreign liabilities that needs to be renewed within a one year period. In addition, liquidity risk is mitigated by holding short-term investments that are matched to the Government of Canada's maturing liabilities in foreign currencies.



### **Securities lending**

As at 31 March 2014, the Account's investments included securities held by its agents in connection with the securities lending program. Investments with a fair market value of \$316 million (\$1,618 million at 31 March 2013) and an amortized cost of \$332 million (\$1,613 million at 31 March 2013) were being used in the securities lending program. A lower fair value compared to amortized cost is attributable to regular market fluctuations.

No securities were lent to eligible borrowers at the reporting date (nil at 31 March 2013).

### **4. Due to the Consolidated Revenue Fund (CRF)**

The Account is funded by the Government of Canada through interest-free advances from the CRF. Advances to the Account from the CRF are authorized by the Minister under the terms and conditions prescribed by the Minister of Finance. Pursuant to section 19 of the *Currency Act*, these advances are limited to \$100 billion by order of the Minister of Finance in September of 2009.

The CRF advances the proceeds of the Government of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF<sup>7</sup> to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions of foreign currency advances from the CRF. Interest payable by the Government of Canada on borrowings in foreign currencies and charges on allocations of SDRs to Canada are charged directly to the CRF.

The Account requires Canadian-dollar advances to settle its purchases of foreign currencies. Canadian dollars received from sales of foreign currencies are remitted to the CRF. This, together with foreign currency payments made on behalf of the Government of Canada, causes reductions in the level of outstanding Canadian-dollar advances, and can result in overall net deposits of Canadian dollars by the Account with the CRF.

At 31 March, advances from the CRF were comprised of the following currencies:

#### **Currency composition of advances from the CRF**

(in millions of Canadian dollars)

	2014	2013
U.S. dollars	50,846	40,189
Euros	18,725	16,456
Japanese yen	317	306
British pound sterling	201	-
SDRs	7,858	6,999
Subtotal - foreign currencies	<u>77,947</u>	63,950
Canadian dollars	(2,087)	(1,969)
Net revenue	<u>1,505</u>	1,401
<b>Total</b>	<b>77,365</b>	63,382